Internal Revenue Service

memorandum

CC:TL-N-408-88
Brl:CEButterfield

date: NOV 24 1987

to: District Counsel, Newark District CC:NEW

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This responds to your letter of October 7, 1987, requesting advice on how to proceed in this case after the adverse opinion in Consumers Power Company v. Commissioner, 89 T.C. No. 49 (1987).

ISSUES

1. Whether a bills-issued taxpayer may accrue income for electricity provided at the time the electricity is billed?
2. Whether connection fees paid to a utility by developers, rather than by the ultimate purchasers of homes, are income to the utility?

CONCLUSION

We recommend that you offer a settlement to the taxpayer as follows. If they will concede the connection fee issue, we will agree to place them on the meters-read method, rather than full accrual. If they do not accept such a settlement, we recommend that you continue to trial in February on the argument discussed below. Your case has been tentatively selected as a test case, if the taxpayer will not accept our settlement offer. In fact, if possible, expedited briefing and opinion schedules should be sought. This avenue can be pursued further with the national office, if you think we may be able to assist you.

FACTS

[redacted] is a bills-issued taxpayer; they accrue income for electricity provided at the time the electricity is billed. The Service has taken the position in previous litigation and in this case, that where a billing cycle is fragmented, that is the meter is read or an estimate of usage is made in one year, and the bill is issued in the next, the proper year for the accrual of the income attributable to the final meter reading or estimate is the year in which such reading or estimate is made, and not in the following year when the customer is billed. The full position of the Service is

that the bills-issued method is an improper accounting method, because it does not accurately reflect income. In making the adjustments from the bills-issued method, the Service places the taxpayer on the full accrual method, requiring that income be accrued as services are supplied. After the rejection of this argument for a hybrid taxpayer in Consumers Power, you have asked us to advise you whether we should concede the fragmented cycles in this case.

Taxpayer has also raised an argument about certain connection fees paid by developers for the provision of electrical hook-ups to their subdivisions. Taxpayer has taken the approach that connection fees paid by developers are not income to them, the utility, because such payments are for the benefit of the developer in the construction of his property, and not for the benefit of the electric company. Service position on this issue is that connection fees are properly includible as income in the year they are received.

LEGAL ANALYSIS

I.R.C. § 446 creates the general rule that taxable income is to be computed under the method by which the taxpayer ordinarily keeps its books. There is an exception to the general rule for methods which do not clearly reflect income. Under section 451, income is to be included in gross income for the taxable year in which it is received, unless the method of accounting used by the taxpayer requires its inclusion in a different year. Such a method must meet the standards of section 446 for accurate reflection of income. For tax years beginning after December 31, 1986, utility companies will be subject to the special provisions of section 451(f), which places such companies on the strict accrual basis, so that income will be accounted for in the year that services are provided.

For the intervening tax years, there are several alternative methods of accrual accounting that have historically been applied by utility companies. One such method is the bills issued method, by which income is accrued for services provided at the time the bill is issued. The strict application of this method creates fragmented cycles at the end of the year -- cycles in which the final meter reading or estimate is made at the end of the year but the bill is not issued until the beginning of the following year. Taxpayers which have employed the bills issued method have historically reported income attributable to fragmented cycles in the year the bill was issued, in spite of the fact that they have deducted their expenses through the end of the year, including the expenses for providing the services for which income has been deferred into the following year, resulting in a mismatching of income and expenses.

In challenging the bills-issued method as impermissible, the Service would use two basic lines of reasoning. First, the all-events test requires that income be accrued in the year in which the right to receive it is fixed, which would be the year in which services are provided. In addition, traditional rules of tax accounting require that income and the correllative expenses be matched. The bills issued method violates this accounting requirement, because income is deferred into a later year, while expenses are deducted based on estimates through the end of the current year. The Service has never permitted the use of the bills-issued method. Even in Rev. Rul. 72-114, 1972-2 C.B. 14, which created the requirements for the Service to permit the use of the meters-read method, income from fragmented cycles is expressly required to be accrued in the year in which the meter reading or estimate takes place.

The Service has had a notable lack of success in litigating the various alternative accrual methods employed by utility companies. We have not, as yet, placed a pure challenge to the bills-issued method before the court. Other cases on related issues, however, indicate that hazards of litigation on this issue are great. The Tax Court in Orange and Rockland Utilities, Inc. v. Commissioner, 86 T.C. 199 (1986), in considering the conformity requirement of Rev. Rul. 72-114, and determining that it was not a sufficient basis to distinguish between taxpayers on the question of deferral of income into the following year for unbilled usage, stated that the deferral of recognition of unbilled revenue was in accordance with generally accepted accounting principles, as the company had no present right to bill for such revenue. 86 T.C. at 312-313. The issue before the court was conformity, therefore the language regarding the propriety of the deferral is arguably dicta, however it is an indication of what the court might do with the deferral issue presented by the bills issued method, in the fragmented cycles. The Court stated that the right to income became fixed when the income was billable (not billed) and the taxpayer could only bill once a month under the state Public Utility Commission's Tariffs. Accordingly, the fact that the meter was read before the end of the year was irrelevant because the income wasn't billable until the succeeding year. Other language in Orange and Rockland, however, discussed below, supports our position on the bills-issued method.

The bills-issued method was also before the Tax Court in Public Service Company of New Hampshire v. Commissioner, 78 T.C. 445 (1982), but again, only on the conformity issue. In that case the court focused discussion on the unbilled amounts, with no discussion of any fragmented cycles. However, the court concluded that a matching of income with expenses is not essential, where other factors such as the item at issue, the method involved and the customary practices within the industry mitigated in favor of the petitioner, which the court found that

they did. (The Service announced its intention not to follow Orange and Rockland and Public Service Co. of New Hampshire in announcement 86-65, 1986-19 I.R.B. 19.)

The First Circuit issued another opinion adverse to the Service, Bay State Gas Co. v. Commissioner, 689 F.2d 1 (1982), which involved the question of budget billing. Because of this adverse opinion, we did not appeal Public Service Co. of New Hampshire, since appeal also would have been to the First Circuit. The Court said no rational justification to distinguish between budget billing customers and regular customers. Since the Service did not require accrual of unbilled revenue with respect to regular customers it could not required accrual for budget billing customers. The court did indicate, however, that under strict accrual such income should be included. The court allowed the Service to require the accrual of income for paid up credit balances to the extent that such credit balances represented estimated use to the end of the year. The primary liability that the Bay State case raises for the Service in the instant case is an additional precedent for the principle that the Commissioner's discretion to alter a method of accounting under section 446 is subject to limitation.

Most recently the Tax Court has considered the fragmented billing issue in the context of determining whether or not Consumers Power Company qualified for the relief provision for meters-read taxpayers in section 821(b) of the Tax Reform Act of 1986. The relief provision stated that although the Act placed all utilities on strict accrual for years beginning after 1986, for years before the effective date taxpayers who were using a method based on the reading of meters could continue to do so without challenge.

The taxpayer in Consumers Power Co. v. Commissioner, 89 T.C. No. 49 (1987) was employing a hybrid method of accounting, by which most districts were accrued on the meter reading date, but some were not accrued until the bill was issued. It should be noted that the Service stipulated that the taxpayer was a meters-read taxpayer in that case, arguing that the taxpayer should be allowed to use the method but should be required to employ it consistently. The court found that the variance of two meter reading days out of 250 was de minimis, and would not take taxpayer out of the paramaters of the relief provision. In considering the two fragmented cycles, the court stated that it had considered accounting methods like that of Consumers in earlier cases and had found them to be allowable. The strong implication of Consumers Power is that if the Tax Court were asked to consider the bills-issued method directly, something that it has not as yet done, it would find it to be an allowable

method under section 446 as well. We anticipate that an appeal will be necessary to make any headway with our position that the bills issued method does not clearly reflect income, and that it is within the discretion of the Commissioner to place a bills-issued taxpayer on a meters-read basis, thus requiring the accrual of income from fragmented cycles in the earlier year.

Obviously, in bringing such a case we must be particularly mindful of the need to distinguish it from the case before the Court in Consumers Power, and to bring it outside the rather broad language of that opinion. In the course of doing so, we will attempt to pursuade the Tax Court that the language in Consumers Power went too far, and encourage them to clarify it and narrow it to make it clear that they did not intend to include bills-issued taxpayers in their sweeping interpretation of the relief provision in section 821(b).

A close examination of the facts in Consumers Power will be necessary to distinguish it successfully, as the legal arguments we would make in this case are substantially the same. The issue before the court in Consumers Power was originally a challenge to the method of accounting employed since it did not clearly reflect income under section 446. During the course of the litigation the relief provision in section 821(b) was passed, rendering a challenge to the meters-read method moot, so the issue became more narrowly focused -- whether the taxpayer fit within the language of the relief provision. The Service did not dispute that the taxpayer was principally a meters-read taxpayer. We asserted that the taxpayer was using a hybrid method which resulted in the fragmenting of some billing cycles, and that the income from some, but not all, of the fragmented cycles was being accrued in the later year.

We asserted that to fall within the relief provision the taxpayer would have to follow the strict requirements of the meters-read method, so that the use of a hybrid method by Consumers Power took it outside the relief provision. We argued that the taxpayer should, at the least, be required to apply their chosen method consistently, and accrue income from fragmented cycles based on the meter reading or estimate in the earlier year.

Consumers Power asserted that their method clearly reflected income, was a permissible method for the inclusion of income under section 451, and fell within the relief provision. They argued that the relief provision should be broadly construed, to give it its intended effect, because most utilities employed methods at variance in some manner with the pure meters-read method, and if such variant methods were not considered to fall within the relief provision, it would apply to few if any taxpayers. The court accepted this argument. Because it

found that the method as it was employed fell within the grant of relief, it was not necessary for the court to reach any conclusions regarding whether or not the method was otherwise permissible under the Code, however they gave every indication that if it were required to make such a finding, it would hold that the method was permissible.

Although we believe this interpretation of the relief provision to be incorrect, and will challenge it in this case, we must also assert that our case is manifestly different from Consumers Power. We can do this because [redacted] is admittedly not a meters-read taxpayer, but a bills-issued one, and the fragmented cycles in this case were not aberrational, but a natural result of the consistent application of taxpayer's method of accounting.

In arguing this case, we must mimic to a great extent the arguments that were made in Consumers Power. We will assert that the burden is on the petitioner to demonstrate that the Commissioner abused his discretion in requiring an adjustment to petitioner's accounting method. Thor Power Tool Company v. Commissioner, 439 U.S. 522 (1979). It is well established that the Commissioner's discretion in such matters is very great and should not generally be interfered with. Lucas v. American Code Co., Inc., 280 U.S. 445 (1930); Brown v. Helvering, 291 U.S. 193 (1934). The taxpayer is asserting that it is not required to report income until an account is billed, as all events fixing the right to receive income have not taken place until the amount is billed. In spite of the general language in the cases taxpayer cites in its favor that alternative accrual methods in general use in the industry are acceptable methods of accounting and that the Commissioner lacks the discretion to make an adjustment to them based solely on a challenge to the method, there is no case precisely upholding the point urged by the taxpayer.

We should assert that all events have transpired fixing the right to receive the income when the energy is supplied, and that the meter reading and billing process is merely ministerial.

We would argue that the all-events test requires that ulitities follow the full accrual method of accounting, which Congress endorsed in the Tax Reform Act of 1986. In placing taxpayers on the full accrual method, in the interest of limiting further controversy, relief would be granted to a limited group of taxpayers already employing the meters-read method. All other taxpayers using the various hybrid methods would be unaffected by the relief provision, leaving the

Commissioner free to continue to challenge their methods under section 446, as not truly reflective of income.

There are numerous cases holding that the income should normally be reported on an annual basis, and not on the basis of transactions. Burnet v. Sanford & Brooks Co., 282 U.S. 359 (1931); Security Flour Mills Co. v. Commissioner, 321 U.S. 281 (1944); United States v. Consolidated Edison Company of New York, 366 U.S. 380 (1961). In addition, income is generally held to be includible in the year in which the right to receive it accrues. Spring City Foundry Co. v. Commissioner, 292 U.S. 182 (1934); Guaranty Trust Co. of New York v. Commissioner, 303 U.S. 493 (1938). Accrual basis taxpayers providing services have also been required to accrue income at the time that services are performed. Schlude v. Commissioner, 372 U.S. 128 (1963); American Automobile Association v. United States, 367 U.S. 687 (1961).

The recent Supreme Court case of United States v. Hughes Properties,Inc., ___ U.S. ___, 106 S.Ct. 2092 (1986) lends support to our argument. In Hughes Properties the issue was the proper year for the accrual of a deduction of amounts on the face of progressive slot machines. The face amounts on these machines was fixed by state law and could not be reduced except after a winning pull of the handle. Therefore, although the payout date was uncertain, the amount on the face of any machine at the close of the taxable year was certain to be paid out at some time in the future. The Court held that where the liability was fixed by law, and could not be reduced, the amount was deductible even though the exact date of payout was unknown. The same theory can be readily applied to income attributable to the utilities for services provided through the end of the year. Once the product has been provided and consumed, it will be billed. The meter reading and the sending of the bill are merely ministerial functions going to the time at which the amount will be collected, and not to the ultimate entitlement of the utility company for goods or services already provided.

In addition, we would argue that the mismatching of income and expenses creates a distortion of income, which the Commissioner in his discretion is also empowered to correct. United States v. Catto, 384 U.S. 102 (1966); Commissioner v. South Texas Lumber Co., 333 U.S. 496 (1948).

We would assert as an alternative that the petitioner should be placed on the meters-read method. In support of this assertion we can point to the language of the Tax Court in Orange and Rockland, 86 T.C. at 214:

> The billing and termination of service regulations and rate tariffs of the applicable

> public utility commissions are such that the occurrence of the respective cycle meter reading date in January is the critical event necessary to fix petitioner's right to unbilled December revenue and renders such services billable. Billing is purely a ministerial act which has no effect on petitioners' revenue recognition treatment. Petitioners accrue revenue as of the cycle meter reading date, not the billing date.

The legislative relief provision also sanctions the use of the meters-read method, but does not address the legitimacy of the bills-issued method. The Conference Report states that the intention of the relief provision was to leave any pending litigation on methods other than the meters-read method unaffected. "No inference is intended as to methods of accounting for utility services not described in the preceding sentence (e.g., a method of accounting which takes income into account on the basis of the date the customer is billed for utility services)." H.R. Rep. No. 841, 99th Cong., 2d Sess. II-323 (1986).

The Tax Court language in Orange and Rockland that all events fixing the right to receive income have transpired on the reading of the meter, coupled with the language of the conference report provide good support for our assertion that the bills-issued method is not covered by the relief provision, and is not a permissible method of accounting under sections 446 and 451.

In arguing that petitioner's method does not clearly reflect income, we will not raise the conformity issue, or the unbilled revenue issue. We will focus purely on the use of the bills-issued method, and the resultant fragmented cycles. Petitioner misplaces its reliance on Orange and Rockland, and the other cases referred to in the Revenue Agent's Report in this case. None of these cases support the proposition that the bills-issued method is an acceptable accounting method for tax purposes, and the above cited language in Orange and Rockland lends solid support to the opposite contention. Moreover, the issue for the court is not whether the taxpayer's method clearly reflected income, but whether the Commissioner had sufficient basis in law for the conclusion that it did not. RCA Corporation v. United States, 664 F.2d 881 (2d Cir. 1981).

We would also assert that taxpayers' business of delivery of gas and electricity constitutes the sale of a good or product rather than the furnishing of a service. The court in Orange and Rockland disagreed with us on this point, however numerous other courts have adopted the Service's position. City Gas Co.

of Florida v. Commissioner, T.C.M. 1984-44; Gas Light Co. of Columbus v. Commissioner, T.C.M 1986-118. The proposition that gas is a good is supported by its inclusion in inventory. Engle v. Commissioner, 76 T.C. 915 (1981) rev'd on other grounds, 677 F.2d 594 (7th Cir. 1982), aff'd, 464 U.S. 206 (1984); Las Cruces Oil Co. Inc. v. Commissioner, 62 T.C. 764 (1974); Northern Natural Gas Co. v. Commissioner, 44 T.C. 74 (1965), aff'd, 362 F.32d 781 (8th Cir. 1966). Electricity should also be classified as a good because it is produced by the employment of labor and machinery, and is a consumable product. Curry v. Alabama Power Co., 243 Ala. 53, 8 So.2d 521 (1942); Minnesota Power & Light Co. v. Personal Prop. Tax, Taxing Dist., 289 Minn. 64, 182 N.W.2d 685 (1970); Spillman v. Interstate Power Co., 118 Neb. 770, 226 N.W. 427 (1965). The sale of electricity under the Uniform Commercial Code is also considered the sale of a good. Pennzoil Co. v. Federal Energy Regulatory Commission, 645 F.2d 360 (5th Cir. 1981).

The significance of this distinction is that income from the sale of goods is reportable when all the events have occurred that fix the right to receive the income and the amount thereof can be determined with reasonable accuracy. Treas. Reg. §§ 1.446-1(c)(1)(ii) and 1.451-1(a). For sale of services, however, income is to be recognized when the services have been performed and are billable. Decision Inc. v. Commissioner, 47 T.C. 58 (1966), and Cox v. Commissioner, 43 T.C. 448 (1965), Orange and Rockland, supra. The importance of this distinction is not great in this instance, because even if the court continues in its holding that the taxpayer is in the business of selling services, it has itself stated that the meter reading date fixes the right to receive the income, and that the billing is merely a ministerial function.

Recent Supreme Court cases on the subject of the all-events test as it applies the the accrual of deductions lends further support to our assertion that income should be accrued by the utilities when the meter is read, and not deferred until the accomplishment of a merely ministerial function. United States v. Hughes Properties, Inc., ___ U.S. ___, 106 S.Ct. 2092 (1986) and United States v. General Dynamics Corp., et al., ___ U.S. ___, 107 S.Ct. 1732 (1987).

Also raised by the taxpayer in [redacted], is the issue of whether what are admittedly connection fees, paid by developers and not by individuals, are includible as income to the utility company. Petitioner has made the assertion that these fees do not fit within the definition of gross income when they are paid by developers as they are paid for the benefit of the developers in constructing their developments, and not for the benefit of the utility. However, connection fees are currently includible in income. Connection fees are those fees charged to connect a customer to a main service line. Lake

Superior District Power Co. v. Commissioner, 701 F.2d 695 (7th Cir. 1983). For the tax years at issue, connection fees were defined in the code as amounts paid to connect the customer's line to a main line. Connection fees were defined in Senate Report No. 95-1263, 95th Cong. 2d Sess., 480 n.4 (1978), as

> amounts paid to connect the customer's 'property' to a main water or sewer line. The bill revises the statutory language to refer to amounts paid to connect the customer's "line" to a main line. This language change was made to reflect the inclusion of public electric utilities. Thus, it is clear under the bill that, where the main line is located on or under the property of the customer, a customer connection fee does not include amounts for the installation of the main line. However, a customer connection fee includes amounts for the installation of the connecting line between the main line and the customer's line located in his home (or other place where the customer's ownership of the line begins) regardless of whether that connecting line was located on or under his property or the property of another.

The legislative history does not distinguish between individual customers and developers. There is no basis in the statute or the legislative history for such a distinction to be drawn. The connection line is defined as that line which connects the privately owned portion of the line, that in the customer's house, to the main line owned by the utility. There is no requirement that the connection fee be paid by the customer to be included as income by the utility. The natural interpretation of the statute is that amounts received by the utility for the connection of lines in homes to main lines is includible as income, no matter who pays those connection fees. There is no basis in case law, statute, or legislative history for the utility's conclusion that amounts which admittedly fit within the definitions in the statute are nevertheless not included as income (therefore are presumably contributions in aid of construction, as they must have some status under the tax code) simply because they were paid by the developer and not the ultimate purchaser of the home.

The Code provides that connection fees include amounts paid for the stated purposes. It does not draw a distinction based on fees paid by developers and fees paid by individual customers. [redacted] " is asking us to make a distinction that Congress did not make. ... Our task is to interpret the statute's words in their ordinary, everyday senses, and not to put words into the statute that Congress did not put there." Lake Superior, 701 F.2d at 702. There is no basis for the

argument made by the petitioner. Their argument is not well supported by petitioner, and is contrary to Service position. Under section 118(b), contributions in aid of construction are capital contributions to a utility, and not subject to tax, connection fees are income in the year received. Thus we do not recommend conceding this position.

We understand that the taxpayer might be willing to concede their position on this issue, in an acceptable settlement offer. We have suggested that you offer a settlement based on putting the taxpayer on the meters-read method in exchange for their conceding the connection fees question. If they do not agree, we will make this case a litigating test of the fragmented billing issue. Should a better vehicle present itself, or should a decision be made to concede the fragmented billing issue, we will advise you of that, and discuss an appropriate position for settlement.

If you have any questions regarding this matter, please do not hesitate to call Ms. Clare E. Butterfield at (FTS) 566-3521.

Sincerely,

PATRICK J. DOWLING
Acting Director

By: Gerald M. Horan
GERALD M. HORAN
Acting Chief,
Branch No. 1
Tax Litigation Division